Project Syndicate

Long Reads

How Stable Is the Global Financial System?

Sep 29, 2017 | **BENJAMIN J. COHEN**

SANTA BARBARA – Just over a decade ago, on August 9, 2007, the French bank BNP Paribas limited investors' access to three of its money market funds, worth a total of around $2.2 billion. The BNP freeze was unprecedented, but it received little attention outside the financial world at the time.

It would later prove to be the canary in the coal mine. In the months that followed, payment systems and capital markets seized up everywhere, and the global financial system narrowly avoided total collapse. By late 2008, the world was facing the worst economic crisis since the Great Depression.

Even after a decade and as the US Federal Reserve, the Bank of England, and the European Central Bank begin to normalize interest rates and move away from the extraordinary policies (quantitative easing in particular) used to confront the crisis, we are still trying to decide what lessons to draw from that near-death experience. And while much has been done to reduce the risk of a repeat performance, a critical question remains: Are we safer now than we were ten years ago?

Whether or not recent policy reforms are enough to sustain global financial stability is a matter of intense debate – one in which *Project Syndicate* commentators have been prominent participants all along.

How It Happened

Few would question the advantages of an open, competitive global financial system. Broad, deep, and resilient financial markets are essential to keeping the wheels of global commerce turning. They help savers diversify risk, and enable borrowers to obtain credit at lower cost. And they confer the benefits of convenient exchange and capital certainty on everyone.

But a global financial system also has distinct disadvantages. Above all, it is prone to crisis. As former US Federal Reserve Chairman Paul Volcker pointed out in 2012, all "financial systems, whether in Asia in the 1990s or a decade later in the United States and Europe, are vulnerable to breakdowns."
Crises can take a long time to develop. But once they erupt, Allianz chief economic adviser Mohamed El-Erian explains, "they tend to spread rapidly, widely, violently, and (seemingly) indiscriminately," as "overall financial conditions quickly flip from feast to famine." We know this because such crises have been a recurring, painful feature of financial markets ever since the first banks emerged in the city-states of Renaissance Italy. Of course, like Leo Tolstoy's unhappy families, each "unhappy in its own way," the particulars of financial crises will always differ, with each inflicting its own type of pain.

In a nutshell, BNP Paribas's canary drank itself to death, as global capital markets binged on debt. Most observers agree that the crisis started in the US, with the swelling of a real-estate bubble that ultimately burst in mid-2007. But subprime mortgages in America were only the tip of the iceberg. Beneath the surface, massive accretions of risky derivative claims had been allowed to pile up worldwide, as investors and institutions sought ever-more liquidity and leverage. Once asset prices began to sink, many claims became toxic. And when everyone dashed for the lifeboats, they almost capsized the ship.

More fundamentally, notes Stefan Gerlach, a former deputy governor of the Central Bank of Ireland, the crisis was due to "a combination of weak internal risk management and inadequate government regulation." On the one side were bankers and others who, convinced of their own financial acumen, had become increasingly blind to the dangers latent in recent market innovations. And on the other side were national supervisory authorities inclined to leave the sector to its own devices and trust that it would self-correct as needed.

In hindsight, it is clear that both sides let themselves be seduced by the relative calm that had prevailed since the 1997 Asian financial crisis. In an era that became known as the Great Moderation, notes Jim O'Neill, a former chairman of Goldman Sachs Asset Management, "complacency had set in." This sanguine mood was captured by the tongue-in-cheek title of a serious 2009 book by Harvard University's Carmen Reinhart and Kenneth Rogoff. In *This Time is Different*, Reinhart and Rogoff showed that the run-up to the latest crash wasn't really different at all. It was part of an age-old pattern.

All Hands on Deck

At the height of the crisis in 2008, Harold James of Princeton University recalls, politicians concluded "that they could not rely on business as usual." In order to prevent a total collapse, most of the G20 governments – including the two largest economies, China and the US – "launched large-scale stimulus programs." At the same time, central banks stepped in “to provide liquidity on a massive scale” for frozen financial markets. Remarkably, these initiatives worked. The so-called Great Recession actually turned out to be a brief v-shaped downturn, after which global growth resumed, albeit haltingly, and monetary conditions stabilized. Government leaders, James concludes, “were right to pat themselves on the back for having prevented a repeat of the Great Depression.”

This was particularly true of the Fed, which quickly stepped in as a global lender of last resort, by agreeing to currency swaps with 14 other central banks, so that they could meet their economies’ demand for dollars. At its peak in December 2008, the Fed’s outstanding credit under these arrangements totaled $580 billion, together with an additional $500 billion or more through various programs to support private banks abroad. As James wrote in 2014, the Fed “effectively emerged from the crisis as the world’s central bank.”

Once it became clear that another Great Depression had been averted, policymakers shifted their attention to the financial sector, where, as Antonio Foglia of the Institute of New Economic Thinking points out, “around half of the 101 banks with balance sheets larger than $100 billion as of 2006” had failed. The ensuing reforms, Simon Johnson of MIT Sloan explains, focused primarily on financial institutions that “were so large relative to the economy that they were ‘systemically important’ and could not be allowed to go bankrupt.”

To a surprising degree, notes Howard Davies, the Chairman of the Royal Bank of Scotland, “Governments that had been suspicious of international interference” were suddenly “eager for tougher global rules to prevent banking crises from spilling across borders and infecting others.” Those rules would come from global standard-setters such as the Basel Committee and the Financial Stability Board (FSB), which was established in April 2009 as an expanded version of the old Financial Stability Forum. The Basel Committee, operating under the aegis of the Bank for International Settlements, issued a broad set of post-crisis banking rules, known as Basel III, in 2010-2011. And the FSB regularly convenes central bankers and financial regulators from more than two dozen countries to monitor global risks and coordinate supervision.

As a result of these efforts, banks in advanced economies are now required to bolster their risk-absorbing capital reserves, clean up murky balance sheets, increase liquidity, improve transparency, narrow the scope of high-risk activities, and realign internal incentives to discourage reckless behavior. Moreover, governments now conduct regular “stress tests” to assess financial institutions’ solvency. And, under the 2010 Dodd-Frank Act, the biggest US banks are obliged to develop “living wills” to ensure an orderly bankruptcy.

Patient Zero

El-Erian speaks for many when he declares that “ongoing efforts to buttress the global financial system have undoubtedly paid off, especially when it comes to strengthening capital cushions and cleaning up balance sheets.” But he is quick to note that “it is too early to declare victory.” Similarly, Gerlach cautions against overestimating “the crisis-preventing power of the new regulatory environment.” For him, “the danger of another financial crisis” cannot be ruled out, given the systemic risks that remain.

For example, Mark Roe of Harvard Law School identifies “a serious weakness in the global financial system’s architecture” that still has not been addressed: “the trillion-dollar overnight repo market in housing mortgages.” According to Roe, reforms to this area of the financial sector fall short, “largely because they depend on the authorities and the banks to complete a complex and untested repayment process within 48 hours of a bank’s collapse.” If an “economy-wide financial event” occasions the “simultaneous collapse of multiple financial firms,” he warns, this process would be “extremely difficult,” if not impossible, to complete. Roe worries that when the US housing market retreats, as it eventually must, “financial stability could be threatened” once again.
Similarly, Johnson contends that, despite Dodd-Frank’s living-will proviso, “there has been almost no progress in terms of ensuring that large financial firms actually can go bankrupt.” American legislators have effectively reached a stalemate over how best to “finish this important piece of Dodd-Frank business.” And as New York University’s Nouriel Roubini reminds us, banks are confronting a number of new challenges, such as “the rise of financial technology that threatens to disrupt their already-challenged business models.”

More broadly, notes Nobel laureate economist Robert Shiller, no policy responses to the last crisis “can anticipate all the kinds of change in narratives that underlie public animal spirits.” He worries that even though the world’s 24 largest economies have formally agreed to adopt Basel III’s risk-based capital requirements, those mandates “may not be high enough.” And, at any rate, “there has been much less progress in a dozen other regulatory areas that the FSB tabulates.”

Indeed, according to the FSB’s latest annual progress report, adoption of Basel III standards on leverage, funding, and other areas has been spotty, at best. The problem, according to Davies, is that “many countries, while ostensibly supporting the development of tighter global rules, have been taking other measures to protect their own financial systems.” Thus, from his perspective, “the future for global standards looks more uncertain than it has for some time.”

Another problem is that US and eurozone regulators disagree on the role that a bank’s internal models should play in measuring its assets. Because US and European financial institutions have different lending practices and asset portfolios, negotiations over this issue have dragged on for years. Given these hurdles, a degree of caution seems warranted. The defenses in place today are certainly better than they were before. But no one can account for every possible contingency that might befall the banking sector. Shiller is right to warn that unforeseen events “may once again reveal chinks in our financial armor.” Bankers and regulators alike should heed the Boy Scout motto: Be prepared.

Migrating Risks

Another area of concern lies outside of formal banking. By focusing so intently on traditional banks, governments may be overlooking other potential threats, like a general who prepares for the next war by reenacting the last one. Gerlach, for his part, analogizes the current “regulatory environment” to “a new highway: It is technically safer than a country road, but it also attracts more cars that are traveling at much higher speeds, so traffic accidents continue.”

Once we start looking for threats on the road ahead, they are not difficult to see. For example, Shiller points to the danger of money market funds, which offer “somewhat higher interest rates, but without the insurance that protects bank deposits in many countries.” Money market funds have increasingly become “an alternative to banks for storing one’s money,” and could be ruined “if a large number of people try to withdraw their money at the same time.” It is as if we had traveled back in time to the nineteenth-century era of wildcat banking.

Similarly, El-Erian worries about the unintended consequences of banks being subjected to tougher rules than non-banks. He points out that “more carefully regulated banks have ceased certain activities,” only to be replaced “by non-banks that are not subject to the same supervisory and regulatory standards.” Moreover, he describes “certain segments of the non-bank system” as being “in the grips of a ‘liquidity delusion.’” In the absence of proper supervision, companies are offering products that “risk over-promising the liquidity they can provide for clients transacting in some areas – such as high-yield and emerging-market corporate bonds – that are particularly vulnerable to market volatility.”

And then there are the dangers that we have not yet detected, what former US Secretary of Defense Donald Rumsfeld famously called “unknown unknowns – the ones we don’t know we don’t know.” Somewhere in the complex recesses of global finance, there are almost certainly unknown unknowns that could trigger a new crisis. “[I]t would be premature,” El-Erian rightly warns, “to assert that we have put all the risks confronting the financial system behind us.”

Central Bankers Gone Wild

A third area of concern is monetary policy. Central banks played a key role in rescuing the global economy back in 2008-2009, by pumping enough liquidity into the system to keep it afloat. But many observers now fear that central banks wouldn’t be able to muster such a response again, if needed.

Central banks are inherently conservative, and can be slow to react in the face of sudden shocks. And as Davies reminds us, they “were widely seen to have been dozing at the switch through the early years of this century.” In addition to allowing “global imbalances to build up,” central bankers “looked benignly on a massive credit bubble, ignored flashing danger signs in the mortgage market, and uncritically admired the innovative but toxic products devised by overpaid investment bankers.” When the collapse came, the minders of the money were as surprised as anyone.

Moreover, many central banks’ initial reaction to the last crisis was sluggish and unsure. Davies, not without a touch of sarcasm, observes that, “The Bank of England lectured on moral hazard while the banking system imploded around it, and the European Central Bank continued to slay imaginary inflation dragons.” Not until the Fed stepped in did other central banks become more proactive.

Whether central bankers have learned from their mistakes remains to be seen. Yale’s Stephen Roach surmises that they have not. Indeed, once they launched unconventional policies such as quantitative easing (QE) and ultra-low interest rates, they couldn’t stop. All of the excess liquidity being pumped into financial markets, he warned in September 2016, was encouraging “reckless risk taking,” and creating an “environment of asset-based excess” not unlike that which “incubated the 2008-2009 global financial crisis.”

Of course, in the absence of sustained fiscal stimulus after the Great Recession, unconventional monetary policies were arguably justified by the need to keep a sluggish recovery from faltering. And in September of this year, the Fed announced that it would finally begin to shrink its bond holdings, and hinted that another modest interest-rate increase could come as soon as this December.

Still, Roubini worries that, with the benchmark rate at 1-1.25% today, “even if the Fed can get the equilibrium rate back to 3% before the next recession hits, it still will not have enough room to maneuver effectively.” In the case of another downturn, he warns, “[i]nterest-rate cuts will run into the zero lower bound before they can have a meaningful impact on the economy.” Echoing this point, Gerlach argues that “the tools available to central banks to prevent deflation and a collapse of the real economy are severely constrained.” That means that “if a financial crisis were to occur today, its consequences for the real economy might be even more severe than in the past.”

Complicating matters further, central bankers have become the targets of a public backlash. Having acquired far-reaching macroeconomic and regulatory powers after the 2008 crisis, they are now seen as “over-mighty citizens” in need of more oversight. As Davies puts it, “an institution buying bonds with public money, deciding on the availability of mortgage finance, and winding down banks at great cost to their shareholders demands a different form of political accountability.”

The problem is that political oversight, unless it is "designed with extraordinary care," could undermine central-bank independence. And even the mere threat of lost independence could make central bankers more hesitant to use all of the tools at their disposal, even when circumstances demand it.

The Post-Crisis Ebb

This points to the role of politics in determining whether our economic systems are safe today. The 2008 crisis was immediately followed by a wave of public support for reform, which crested in 2010-2011 with the Dodd-Frank Act and the Basel III agreement. But as memories of the near-death experience have faded, so has enthusiasm for reform. The danger now is that badly needed follow-up measures will not be enacted. "The political window of opportunity for bold actions," El-Erian laments, has "essentially closed."

One such action would be to strengthen the FSB, which, as Ngaire Woods of Oxford University points out, "has no legal mandate or enforcement powers, nor formal processes for including all countries." But proposals to expand the FSB's mandate have met with indifference. For the time being, Woods concludes, the FSB will remain "a 'standard setter' in a world with strong incentives to evade standards and negligible sanctions for doing so."

Worse, there is now mounting political pressure to reverse key post-crisis reforms. US President Donald Trump has not hidden his distaste for both Dodd-Frank and Basel III. "Making America great again," Davies muses, "is not likely to involve new enthusiasm for more intrusive rules."

Indeed, almost immediately upon taking office, Harvard University's Jeffrey Frankel writes, "Trump issued an executive order directing a comprehensive review of the Dodd-Frank financial-reform legislation," with the goal of scaling back "significantly the regulatory system put in place in response to the 2008 financial crisis." Then, in June, the US Treasury Department published a 150-page paper detailing the Trump administration's proposals to deregulate large financial institutions. The plan prompted an immediate public rebuke from both Fed Chair Janet Yellen and her vice chair, Stanley Fischer, among many others.

At the international level, Davies argues that banking rules could stand to be rationalized, given that they have grown in complexity since 2008. But that is not to support "a return to a pre-crisis free-for-all." Once the political pendulum begins to swing back toward deregulation, financial institutions can be counted on to press for as much leeway as possible. Sooner or later, the age-old pattern of hubris, vulnerability, and crisis will re-emerge, and another canary will die.

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